
**FOREIGN OWNERSHIP AND CONTROL OF U.S. AIRLINES:
PROSPECTS FOR CHANGE**

Remarks of

**Jeffrey N. Shane
Partner
Wilmer, Cutler & Pickering**

before the

25th Annual FAA Aviation Forecast Conference

“Aviation 2000”

**Washington Convention Center
Washington, D.C.**

March 7, 2000

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I am reminded that we are all participants in the FAA's annual Forecast Conference. As everyone knows, the FAA's forecasts are uncannily accurate. That worries me because as we move in this session from the quantitative to the aeropolitical--or, as some might say, from the quantitative to the quixotic--I feel that we are probably putting the FAA's superb record of accuracy at serious risk. I would just like to take a moment, therefore, to publicly apologize to Jane Garvey for all the wrong guesses that I'm about to make.

Background

Let me offer a bit of background on the foreign ownership rule in the United States. I think most of you are familiar with it, and so I promise not to spend very much time on the details.

The basic rule, of course, is that all U.S. airlines must be substantially owned and effectively controlled by citizens of the United States. Numerically, 75 percent of the voting securities of a U.S. airline must be owned and controlled by U.S. citizens. Two-thirds of the

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officers and directors of a U.S. airline must be U.S. citizens. A corollary rule is that there can be no semblance of control over a U.S. airline by foreign citizens. That second rule is not enshrined in statute but is instead the product of 40 or 50 years of decisions coming out of the Civil Aeronautics Board and then the Department of Transportation. The control rule is probably the more important feature of the overall framework relating to foreign ownership.

There have been proposals over the years to increase the ceiling on the amount of voting shares that can be held by foreign citizens from 25 percent to as much as 49 percent. Those proposals have not yet produced any change in the legislation. I'm not aware of any proposal to change the "semblance of control" rule. That is to say, even if you increase the maximum amount of shares that foreign citizens can hold from 25 percent to 49 percent, the prohibition on the exercise of control would remain. It is reasonable to wonder whether foreign citizens would be any more interested in investing in U.S. airlines than they are today.

Essentially, they would still be passive investors, as they are under present law. And it's that relegation to the role of a passive investor, I think, that has served as the biggest disincentive to foreign citizens who might otherwise seek to invest in U.S. airlines.

The foreign ownership issue is important today for a number of reasons. One reason is the current state of the U.S./U.K. aviation relationship. I want to talk about that in a moment. A second reason is the quality of competition in the U.S. domestic aviation market. Another reason might be airline valuations.

Finally, the issue will be seen as important in the context of a recent proposal by a group of European airlines to formulate a new "Transatlantic Common Aviation Area" which, by definition, would eliminate all restrictions on foreign ownership both here and in Europe. In effect, airlines based in the Transatlantic Common Aviation Area, meaning the United States and the European Union, would have the ability to do business anywhere in that area. No longer would there be any foreign ownership restrictions as to the airlines domiciled and operating within the TCAA.

U.S.-U.K. Aviation Relations

Let me talk about the U.S./U.K. relationship. In 1992, British Airways proposed to invest \$750 million in US Airways--then known as US Air. Along with that investment would have come a lot of changes in corporate governance--changes which BA maintained did not violate the control rule. They certainly didn't ask for more than 25 percent of the voting shares of US Air. They maintained that the investment, even with those changes in governance, passed muster under U.S. law and policy.

Our view at the Department of Transportation was quite different. It looked to us as though the changes in governance actually would have established something pretty close to control. Although it is a somewhat subjective question, we thought that the BA proposal clearly would have resulted in more foreign control than our policy allowed.

I was intrigued by the BA proposition, however, because we had been trying to figure out how to break the back of some of these old rules and allow a freer flow of capital across borders and to allow alliances to function as efficiently as possible. We had already embraced the concept of alliances as good for international aviation competition and thus good for consumers. Far from being opposed at the outset to the proposal which British Airways brought to us, therefore, we felt that it was something worth considering seriously.

Now it was clear to us, of course, that had we simply approved that proposal, British Airways in effect would have bought for cash a huge amount of incremental access to the U.S. market. We felt that market access on that scale was probably all BA would really ever need, and so it was obvious that, if we were going to find a way to authorize BA's investment in US Air, we would require, at a minimum, some reciprocal market opening on the other side of the Atlantic. The U.K., in other words, would have to open up its market to U.S. carriers and facilitate the enjoyment of new competitive opportunities on both sides. In return for that liberalization, we might have found a way to relax our rules sufficiently to provide BA with many of the governance changes they were seeking.

Unfortunately, the proposition was premature. At least as far as we could tell, the U.K. had not yet embraced the concept of moving seriously in the direction of Open Skies or even some more gradual liberalization. And so the bilateral talks about that mutual opening of markets went nowhere. The agreement that I thought might have served as the catalyst for a change in the control policy never materialized. British Airways pulled its proposal off the table and, shortly after the change of Administration in early 1993, came back with a more modest, \$300 million investment in US Air. The changes in governance that had been so intriguing were not part of that transaction.

Now, why am I telling you that story? You will have noted that British Airways was serving Pittsburgh/London up until relatively recently when they pulled out of the market. They pulled out of the market, one assumes, because they weren't able to make money there. US Airways now wants very much to enter the Pittsburgh/London market. They feel that they can make money. Pittsburgh, of course, is a large hub for US Airways and so they're probably right about that. Because the U.S.-U.K. bilateral air services agreement does not currently permit any new U.S. carrier services, however, US Airways is not yet permitted to operate a route between Pittsburgh and London. That problem has led to serious tension between the two governments in their aviation relationship.

The alliance that British Airways and US Air put together in 1993 and 1994, as I think everybody knows, came apart. I don't know why it came apart and I'm certainly not qualified to comment on that. One can surmise, however, that the complete absence of any ability by British Airways to participate in the governance of US Airways may well have something to do with the break-up.

We saw a similar problem even in the KLM/Northwest alliance--one that's doing very well in terms of its ability to serve passengers, but which didn't do very well as long as KLM was an investor in Northwest. So the investment that was initially part of that deal was returned. And there have been other examples of that sort of difficulty. The point is that it's very difficult

for a major investor in an airline to be comfortable with a passive role. Alliances that are based on that sort of relationship are at serious risk.

Think about what would have happened if we could have found a basis for allowing British Airways to enjoy the level of governance that it had originally sought--changes in corporate bylaws, setting up executive committees, establishing some super-majority voting rights and other tools that they had originally proposed in 1992. First, we would have had, in return, some opening of the British market to U.S. carriers. Heathrow would be more accessible to U.S. carriers than it is today. More importantly, it's likely that the alliance between British Airways and US Airways would have produced a much more productive experience for both carriers. Certainly, with US Airways' support at its Pittsburgh hub, BA would have enjoyed far greater success in its London-Pittsburgh service and might not have felt the need to withdraw.

I mentioned that BA's pulling out and US Airways' inability to get into that market is one of the principal reasons why there is such tension today between the U.S. and the U.K. For that reason, it's not too much of a stretch to say that the restrictions on foreign ownership and foreign control are in a very important way at the heart of that tension.

The U.K. is seeking a relaxation of U.S. ownership and control restrictions. Indeed, that has been a core position of the U.K. government for as long as I can remember. Virgin Atlantic² has made no secret of its interest in setting up an airline in the United States. At one point it was thinking about being a partner in JetBlue, the new entrant that just launched service from New York's JFK International Airport. That partnership did not materialize because Virgin concluded that, under U.S. rules, it would necessarily be relegated to the role of a passive investor. Anybody who knows anything about the Virgin Group knows that it simply doesn't do business that way. The net result is that a second U.K. carrier has been unable to pursue legitimate commercial aspirations in our market.

Some people continue to think that this rule doesn't have much of an effect on anything. But it is having a huge effect. Not only is it at the root of the contentious Pittsburgh-London issue, for the reasons I have just explained; it is seriously compromising the relationship between the two most important aviation partners in the world, the U.S. and the U.K. It is the main reason, I think, that we have been unable to forge a more open framework for air services between our two countries.

Domestic Concerns

Beyond international relations, of course, it is possible to take a harder look at the U.S. market and ask whether there's as much competition here today as we'd like to see. Certainly the Congress is concerned about that. The Department of Transportation has expressed concern about it. Is there a reason why we shouldn't have a freer flow of capital across borders? Would the possibility of foreign investment enhance the prospects for new entrants in our market? I

² The speaker serves as U.S. regulatory counsel to Virgin Atlantic.

don't know the answer to that; only the market knows. The important question is whether there is any good reason to prevent that kind of cross-border investment from taking place.

The last point to think about in the context of whether the rules are worth preserving is airline share values. It is commonly said that airlines are under-valued by the stock market. If that's the case, I wonder whether removing some of the restrictions on investors that might like to come in might not have some upward effect on those prices. Wouldn't airline stocks benefit from being traded in a real market as opposed to an unnaturally restricted one?

Prognostications and the TCAA

Will the law be changed? This is where the forecasting comes in and so this is the part that makes me nervous. Some political facts of life: First, labor is opposed to changing the law. They have been adamantly and consistently opposed to changing the law. I think that some elements of organized labor are looking hard at these changes and treating them as issues that need to be addressed seriously. But I have not detected yet any softening of their view.

Second, the U.S. Department of Defense has started paying attention to the foreign ownership issue. From all that I have seen, the Department of Defense seems quite comfortable with the current law and the current policy.

The point is that there's a lot of inertia in favor of the status quo. The question is: What will it take to persuade the U.S. Congress to change the law? What will it take to persuade the U.S. Department of Transportation to change the policy that it has applied for so long? I think the answer is that it will take a very important source of motivation. The U.S. Government will not rethink the issue of foreign ownership unless there's a very good reason to do so.

One possible stimulus, I suppose, might be the proposal of some European airlines to create a Trans-Atlantic Common Aviation Area. Open opportunities to invest and the abolition of control restrictions are essential parts of the TCAA proposition as it's been put forward. If in fact the European Commission gets a mandate, and if the Commission embraces the TCAA as the airlines in Europe have proposed it, it seems likely that an important proposal will be put to the United States. Then it will be up to the European negotiators to demonstrate why the United States should finally abolish these rules that labor and the Department of Defense still like so much. That's the challenge.

I'm not going to predict the outcome of that negotiation. The point I want to leave you with is that it is unrealistic to think that without a negotiation of that magnitude, the U.S. can be persuaded to reevaluate the foreign ownership rules that are currently in place. It has been talked about for a long time. There has been no movement. We ought to learn from that experience. Something new has to happen. Perhaps the TCAA can serve as the necessary catalyst.

Thank you very much.

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